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Harland J. Scarborough
University of Kentucky

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ULTRA VIRES NO DEFENSE IN PRIVATE CONTRACT.

By PROFESSOR HARLAND J. SCARBOROUGH*

In this discussion, unless otherwise indicated, we wish to be understood by the use of the term corporation or private corporation to mean a purely private corporation and at no time to include public, quasi public, or semi-public corporations. Also the expression *ultra vires* will be limited to the meaning "beyond the authority" and shall not at any time mean "illegal" in the sense that illegal is used in the law of contracts between individuals. We are therefore not now concerned about illegal contracts or public, quasi public or semi-public corporations. We shall endeavor to leave out of our discussion the almost endless confusion brought about by the courts by the interchanging of the terms *ultra vires* and illegal. It is the conflict rather than the confusion that we desire to consider. This conflict is largely brought about by two or three main differences or considerations: first, the doctrine of "special capacity" and "general capacity;" second, the difference in concepts concerning public policy—what it is and how it is to be subserved.

For the first, suffice it to say that the business world in America has outgrown the doctrine of special capacity and it may be fairly said that the courts have, to a large extent, recognized this and in their transition from their former position to another ground upon which to rest their opinions many inconsistencies and more confusion have come.

It is upon the second proposition that the modern conflicts come, and it may be suggested that a proper consideration of what public policy is, what it is to subserve and how it is to do it will go a long way in solving the problem. First, let it be said that in less than one out of every hundred of the cases before the courts is there any public policy to be preserved beyond that vague and shadowy notion that has somehow clung to corporate contracts. The direct and effective means of keeping a corporation within its chartered powers is to have the state to use the "big stick," *quo warranto* or *scire facias*. It would seem that the courts have labored under the notion that to allow *ultra vires* of the corporation to be set up as a defense in an action purely private in its nature would be an added de-

*Professor of Law, University of Kentucky.

terment to the corporation to enter upon *ultra vires* contract. A little reflection will show the error existing herein. First of all, as said above, there is in the great majority of such cases no public policy, worthy of the name, involved; and to be perfectly fair and honest in our thinking we shall have to concede that when all the conditions and circumstances in these situations are considered no harm has been done by the corporation having technically overstepped its chartered powers. For example, let us ask what harm to the public was done by the decision in *Whitley Arms Company v. Barlow*,¹ or what harm would there have been by upholding instead of refusing to uphold, the contract in *Marble Company v. Harvey*?² We answer, "No real harm to the public." Now let us ask what harm to the contracting parties by the present holdings, and the answer is, Just that harm and no more that comes by allowing parties to violate with impunity the contract into which they have in good faith entered.

There is no more reason for allowing *ultra vires* to be set up as a defense in an action upon a contract entered into by a corporation outside of its chartered powers, than for allowing the defense of corporate existence to be attacked collaterally. It has been long since settled law that the corporate existence can not be pleaded by or against a corporation in any collateral proceeding and it is hard to understand why the courts should not take the same view in references to *ultra vires* in all those contracts made by a purely private corporation. As said in the be-

¹ 63 N. Y. 62, 20 Am. Rep. 504. In this case, the plaintiff, Whitney Arms Company, was incorporated to manufacture firearms and other implements of war. It entered into a contract to manufacture railroad locks for the American Seal Lock Company, manufactured and delivered the said locks according to the contract. In an action brought against the trustees of the American Seal Lock Company, *ultra vires* was held not a defense and that plaintiff would be entitled to a judgment against the American Seal Lock Company for the debt.

² 92 Tenn. 115, 2 S. W. 427, 18 L. R. A. 252. Marble Company, an Ohio corporation, with its place of business at Cincinnati, was organized "for the purpose of cutting, dressing . . . with other incidental and necessary powers essential to the carrying on said business" and acquired the entire issue of the shares of stock made by a Tennessee corporation engaged in a similar business under a similar charter and known as the McMillin Marble Company. The last acquisition of shares was from Harvey, president of the McMillin Co. In suit by the Ohio company to enforce against Harvey certain stipulations as a part of the contract that he had entered into with it in the sale of the stock, Harvey set up the defense of *ultra vires* of the contract on the part of the plaintiff. Held a good defense.

ginning, we do not extend this doctrine to contracts by corporations of a public or semi-public nature, for the apparent reason that in the very contract made by these corporations the public has an interest and therefore it is perfectly right and proper that *ultra vires* would be allowed to be set up as a defense to an action brought upon the contract that is beyond the power of such public or semi-public corporations, if so doing will subserve any useful or justifiable purpose.

To allow a corporation to enter into a contract with an individual or another corporation in good faith and with the hope of gain to both parties and then to allow one or the other, upon the discovery that it will not be lucrative or will result in financial loss to it, to disaffirm the contract on the ground that it is *ultra vires* of the corporation, does not rest in good conscience. The allowing of this disaffirmance of contract is to allow too easy a way for the corporation to back out of a bad bargain and, as formerly said, subserves no public purpose. It is allowing the corporation and in the one contracting with it to enter into an *ultra vires* contract with the absolute assurance that upon discovery by one of the parties that the contract is not to be as favorable to it as it had hoped when entering upon the same to rescind it without any penalties attaching thereto. This enables it to say to the other party who has been relying upon the contract and has made certain outlays, perhaps, "Bear uncomplainingly the loss that you have sustained to date and any other that you may sustain, that is neither here nor there to me." The court stamps its approval and so it is. Now instead of this working as a deterrent to the corporation from entering into *ultra vires* contracts it has the directly opposite effect. Corporations and those dealing with them know that in such instances the only consequence that does come is that the contract may be declared a nullity and hence why should they be careful as to the contracts they enter into. The matter being cared for in this way, the inactivity of the state is to be expected; whereas if the *ultra vires* of the contract were not allowed to be set up in the civil action on the contract by one of the parties the procedure would be to have the state investigate whether or not the corporation had entered into an *ultra vires* contract and if so it should either have its charter taken by the state or some other proper punishment according to the offense committed. It may

be, and we believe it is, a valuable and necessary thing to recognize *ultra vires* contracts of a corporation but it must be done by the proper authority, namely, in a direct proceeding by the state.³ Now it makes little difference to us whether this refusal to recognize this element of the contract is placed upon the doctrine of an estoppel,⁴ implied warranty, irrelevancy or any other reasonable ground satisfactory to the one applying it, just so *ultra vires* is disallowed as a defense in the civil action on the contract. This is the important thing. We recognize that the doctrine herein contended for is not now the prevailing opinion; but keeping in mind the great changes⁵ that have come about in the last half century in the attitude of the courts toward the *ultra vires* contract, we hazard the opinion that it will be the law within a comparatively short period of time. The doctrine of *ultra vires* is of the court's making, and after its being established, it has given the courts untold trouble in the dealing with it. Courts have been constrained to allow inroads upon their doctrine time and again until it now may be safely asserted that in contracts wholly executed the courts will not allow *ultra vires* to be pleaded to set aside the contract but will leave the parties where it finds them and by the great weight of authority the contract executed upon one side is sustained and a great tendency in the courts to sustain a contract partly executed upon one side if injustice would be done in failure to sustain the contract; but it is with reference to the executory contracts that practically

³ "The doctrine of *ultra vires* is a most powerful weapon to keep private corporations within their legitimate spheres, and to punish them for the violation of their corporate charters, and is probably not invoked too often, but to place that power in the hands of the corporation itself or a private individual, to be used by him as a means of obtaining or retaining something of value which belongs to another, would turn an instrument, intended to effect justice between the state and corporation into one of fraud as between the latter and innocent parties. Such is the modern doctrine. . . . If such a body transcend its powers, it commits a wrong against the state, and ordinarily it is for the state, only, to call it to account for such violation" *Zinc Carbonate Co. v. First Nat. Bk.*, 103 Wis. 125, 79 N. W. 229.

⁴ See cases collected in 29 A. & E. Encycl. of L. 57, note 1.

⁵ By way of illustration, see *Timm v. Grand Rapids Brewing Co.*, 160 Mich. 371, and cases therein cited for some things that thirty or forty years earlier would have been held *ultra vires* and not an implied power; while in *Simpson v. Directors of Westminster Palace Hotel Co.*, 8 H. L. Cas. 712, is an example of a situation that was regarded as constituting a hard problem to determine whether it were *ultra vires* in 1860, which today we would have no trouble in declaring an implied power and not at all *ultra vires*.

all the courts allow *ultra vires* to be set up as a defense and it is with reference to this that we wish these considerations to be especially applied. Whatever may have been the value in the past of allowing this defense it may be said that it has outgrown its usefulness and should be discarded. We have reached a period in industrial development in which we have no use for *ultra vires* as defense in the private action. Parties to a purely private contract have no more interest in one or the other being held to the terms of same from the public standpoint than any other member of the public. To hold a corporation within the straight and narrow way of its chartered power is the business of the state; and to undertake to protect the public interest by mixing this up with private matters not only does not produce but defeats the desired results. To allow a corporation, even tho it has exceeded its given chartered authority to set up *ultra vires* of its contract and thus relieve itself of the burdens of a contract entered into in good faith both upon its own part and upon the part of the one with whom it contracts, has a tendency to cause it to enter into rather than to deter it from the entering upon other *ultra vires* contracts. It is our contention that if we would prohibit the corporation to plead as a defense, when sued upon a contract, that it had no power to enter into it and place the obligation upon the state and the stockholders to see to it that the corporation stay within its corporate authority we would obtain the result that is desired, namely; that corporations do not exceed their chartered power. Proceeding upon the theory that the question of the contract being *ultra vires* of the corporation is only a public concern we are irresistably brought to this conclusion.

It is perfectly proper to ask the question, what of it if a purely private corporation does exceed the particular powers that are given it by its charter? There are those who would be ready with the answer that if we do not hold a corporation within the bounds set there would be no purpose in setting forth in its charter the powers that a certain corporation may exercise. We agree; but this is no answer, for the apparent reason that we all insist that a corporation should stay within its chartered powers. Our split is not on this point but on the point of how we are to keep it within its limits. Our contention is that this

duty does not rest in any way upon the parties to a private contract and has no place in a private action brought by one of the contracting parties against the other. We are not, at any time, unmindful of the necessity of holding the corporation within its chartered powers but let the proper agency for the doing of this thing be invoked. An assumption of power on the part of a corporation is in fact not usually an infringement upon the rights of other persons. Ordinarily, it does not interfere with their personal security, their property, or their personal liberty. The only argument for restricting corporate authority is that of public policy and hence it should be done by the agency of the state. We believe that statutory and common law prohibition should be made applicable to corporations and individuals alike. As said before, the matter of prohibited and illegal contracts is a very different thing from those contracts entered into by the corporation in excess of its power. Under the present industrial situation in this country we should regard that there is practically no fundamental difference between the right of a commercial corporation and the right of an individual to enter into a contract.

The courts hold quite generally that an *ultra vires* contract can be enforced by the court whenever justice demands it. We ask, Why should not the courts always enforce the contracts as made by the parties and leave to the state the responsibility of seeing to it that a corporation should not exceed its chartered authority? Were this the law and applied without any wavering one or two examples being made of a corporation's violation of its charter by the taking of its charter would be effective in bringing about the result desired. Further it would relieve the courts of a large amount of litigation over questions that are of no value from a constructive public policy standpoint. It would cause a corporation or individuals dealing with the corporation to abide their contracts and not allow contracts to be lightly set aside which would produce a result far preferable to that being produced by the present holdings.

It would serve no useful purpose to enter upon any historical investigation of the origin and causes of the erroneous ideas which have prevailed upon the subject. Much confusion has evidently been caused in this, as well as in other branches of corporate law, by the failure to bear in mind the difference be-

tween the purely private corporations and public and semi-public corporations. Municipal corporations are not associations but are sub-divisions of the state government and hence our remarks are not meant to apply to them.

Much has been said about the inability of courts to uphold an *ultra vires* contract of a corporation because it asks the court to maintain a contract that the corporation had not the power to enter into. And not a few assert that it is asking the court to enforce a void contract. The courts find no inconsistency in holding a corporation liable for tort and yet it is perfectly clear that no authority is given or conferred by law to commit a tort. Just so an *ultra vires* contract of a corporation is not void and may be supported by a court just as readily as to hold a corporation liable for its tort. All the more would this course of procedure be found logical if we should bear in mind that no illegal or *ultra vires* contract is before the court when the court takes the stand that it will not allow such to be set up as a defense; until such is allowed to be put in evidence as a defense, presumably there is before the court only a valid contract and hence the court would not be enforcing either a void or *ultra vires* contract by following the doctrine herein set forth.

The invalidity of a contract entered into without capacity has been frequently validated by a subsequent act of the legislature. This, undoubtedly, shows that the lack of authority to enter into a contract is to be regarded as governed by the remedy merely and the question is not at all whether or not there is a contract, because there is no power in the legislature to create the contract between the parties where none exists.

Another objection made to this doctrine is that it would deprive stockholders and creditors of their rights. Reflection upon the matter will reveal that there is no real and valid right that stockholders have in this situation that should be protected. Why should a stockholder be permitted to be the one of many who organize a corporation and place by his vote directors in charge thereof and then unload all of his responsibility to see that the directors do not enter into *ultra vires* contracts on the shoulders of the other party with whom his corporation, thru its directors, contracts? If we would place this responsibility where it belongs, namely, upon the stockholders and directors of a corporation, we would soon free the community of corporations

overstepping their chartered powers, or at least reduce same to a minimum. If every director of a corporation should know that he is the one responsible financially to the stockholders when he undertakes for his corporation to engage in *ultra vires* contracts there would be produced care on the part of directors in the management of corporations with reference to *ultra vires* transactions such as cannot possibly be produced by our present methods. Furthermore stockholders would with greater care select the directorate of their corporations.

As to the insistence that the creditors are wronged by allowing money of the corporation to be used in channels not provided for under its chartered powers, it may be observed that in only a few instances are creditors concerned one way or the other with the consideration as to the channels of corporate investment and the matter of the courts' holding upon the question; and we further believe it only fair to say that in those cases in which there would seem to be some interest, that it is not different in kind than that in the contract between private individuals and is not deserving of more protection by the courts; the matter of the contract is a purely private matter and should be governed by the same laws that govern the private contracts of individuals.

It is beclouding to the thinking to allow circumstances and conditions accompanying an *ultra vires* contract of an insolvent corporation to be compared with those of a solvent individual, for the allowing unequal situations to be compared has a tendency to prejudice the mind against the *ultra vires* contract as tho it were the offender when in truth it perhaps has had no part to play in the situation. It is largely the influence of these outside considerations that have seemingly directed the courts in their decisions under many circumstances. The meaning may be illustrated as follows: Bank B loans X the sum of five thousand dollars upon the distinct promise of X that he will invest it in the building of a home. Without the knowledge of B, X invests the said sum in an entirely different enterprise, making the contract with C. Certainly no one would assert that X could escape liability on his contract with C by setting up that he had not invested his money according to his promise to B. Now in this situation, so far as private contracts are concerned, if we consider X a corporation and the contract with C one be-

yond the power of X to make, our opponents will say it cannot be enforced. There is no more business reason for allowing the enforcement of one than the other. Why, we ask, should not the legal reason follow in this situation the business reason? This view is supported by the case of *Harris v. Independence Gas Company*,⁶ from which we quote at length in note below.

If there is disagreement with the writer in believing that the present business condition in this country demands the adoption of the policy herein set forth, perhaps we could agree that it is fast approaching that situation and that the legal methods employed to care for the situation should be immediately changed. May we not agree that instead of the rule being (as

⁶ 76 Kan. 750, 92 Pac. 1123, 13 L. R. A. (N. S.) 1171. Judge Mason speaking of the cases in which the defendant has been held estopped to set up the defense of *ultra vires* says, "But they hold that it must have some discretion in the manner of carrying out the purposes of its creation—some freedom of action—it is amenable to the same rules of conduct as a natural person, and may estop itself to question the validity of an agreement it has assumed to make, or may acquire the right to invoke a similar estoppel in its own behalf. Where this theory is accepted, recovery may be had upon a contract which is in fact void, simply because its validity can not be put in issue. . . . These cases have been criticized for the use they make of the word 'estoppel' as descriptive of the principle upon which they are based. It is argued that, as a corporation must know the terms of its own charter, and as one dealing with it is charged with like knowledge, neither party to an *ultra vires* contract can be misled in that respect and therefore there must always be lacking an essential element of what could, with technical accuracy, be called estoppel. This, however, is a mere question of terminology. The requirement that one shall be consistent in conduct—shall not occupy contradictory positions, shall not retain the advantages of a transaction, and reject its burdens—is often spoken of as a form of estoppel. The term is convenient and, if inaccurate, is not misleading. This rule of estoppel affords a good working hypothesis to accomplish just results. If it fails to accomplish all that might be desired in a practical way, it is because it is not made sufficiently far-reaching. It is generally held to be inapplicable to purely executory contracts, one reason stated being that, 'Where neither party has acted upon the contract, the only injustice, caused by a refusal to enforce it, is the loss to the parties of the prospective profits, and this is too slight a consideration to weigh against the reason of public policy for declaring it void and not enforceable.' 29 A. & E. Encycl. of L. 49, 50.

"It might seem reasonable that a system that attempts not only to protect a party to an *ultra vires* contract from actual loss, but where equity requires it, to insure to him actual fruits of his bargain, ought for the sake of completeness and symmetry to enable him to insist upon the performance even of a purely executory contract. It certainly seems against conscience that one who has entered into a contract in the expectation of deriving a profit from it may, upon discovering the probability of a loss, repudiate it and escape responsibility by raising the question of corporate capacity. Parties to a contract who deal with each other upon the assumption that one of them is a corporation, are

it now is) that courts, with one exception, will not enforce the executory contract (seemingly for no other reason than that it is executory) and will only enforce the executed and partially executed contracts when injustice would be done by not enforcing them, the rule should be that all of these contracts should be enforced (not allowing *ultra vires* to be set up as a defense) unless by clear reason it is shown that to enforce the contract would result in injustice and be against public policy considered under the light of all the circumstances.

ordinarily precluded from questioning the validity of its organization. . . . So that for the purpose of such private litigation, the body claiming to be a corporation, and having a colorable existence as such, becomes such to all intents and purposes, as much as though it were a corporation *de jure*. And in *Security Nat. Bk. v. St. Croix Power Co.*, 117 Wis. 211, 94 N. W. 74: 'This court, by a series of decisions, has held that, when a corporation enters into business relations not authorized by its corporate grant of power, the doctrine of *ultra vires* can not be used by it, or by the person with whom it assumes to deal, as a means of defeating the obligation assumed. The state alone can take advantage of the abuse.'

"Where a recovery is sometimes permitted under the contract itself, upon the principle of estoppel, the question whether it has been carried out is likewise of manifest importance, there being a difference in degree, at least, between the attitude of one who has merely entered into an engagement in expectation of obtaining an advantage from it, and that of one who has actually reaped its benefits in whole or in part. But the doctrine that only the state can challenge the validity of acts done under color of a corporate charter, if accepted, must necessarily protect an executory contract from collateral attack, equally with one that has been executed. The court is convinced of the soundness of the view that, in the absence of special circumstances affecting the matter, neither party to even an executory contract should be allowed to defeat its enforcement by the plea of *ultra vires*. The doctrine is logical in theory, simple in application, and just in result. It, of course, does not apply to contracts which are immoral, or which are illegal (as distinguished from merely unauthorized), or to those made by public corporations. Nor does it forbid interference by a stockholder to protect his rights as such."